

Reforming the Financialized Business Corporation

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1. Financialization and Economic Performance

The financial crisis of 2008 fed a growing recognition that the US economy has become highly financialized, with a negative impact on economic performance. The formulation of government policies to reform the economic system must derive from an analysis what financialization is, where one locates it in the operation of the economy, and how it affects economic performance. Given the growing size of the financial sector in the US economy, it is tempting to focus the analysis of the impact of financialization on economic performance on the behavior of that sector per se. Certainly the transformation of leading Wall Street banks into legalized, and largely unregulated, gambling casinos is a major part of the problem. Yet the achievement of equitable and stable economic growth – or what I have called “sustainable prosperity” (Lazonick 2009a) – also, and one could argue more fundamentally, depends on innovation and job creation in the “non-financial”, i.e., industrial, sector of the economy.

The purpose of this essay is to provide an analysis of the financialization of the US business corporation. In particular I focus on the growing and changing influence of the stock market on corporate resource allocation. I argue that the key to the problem is the compensation of US corporate executives with unindexed stock options that reward them for stock-price movements that are driven by stock-market speculation and manipulation and that are justified by the ubiquitous ideology that the role of these corporate executives is to “maximize shareholder value”. Whereas speculation was the primary driver of the stock market in the last half of the 1990s into 2000, the primary driver over the past decade has been manipulation achieved through the allocation of massive sums of corporate cash to repurchases of a corporation’s own stock.

I then go on to outline why in terms of innovation and job creation, this corporate financial behavior has had, and will continue to have, a devastating impact on innovation and job creation in the US economy. The problem is not only that the allocation of corporate resources to stock repurchases is at the expense of investments in innovation and new job creation. The problem is also that structural changes in employment that have occurred since the early 1980s – and that I summarize as “rationalization” (plant closings), “marketization” (the demise of a career with one company), and “globalization” (the offshoring of employment to lower wage nations) – have resulted in permanent losses of *existing* “middle-class” jobs in a succession of economic downturns and a succession of “jobless recoveries”. Although, initially at least, these changes in employment have had productive rationales, the financialization of corporate resource allocation has become largely responsible for the extent of the job losses and the failure to replace them with opportunities for higher value-added employment in the US economy. Based on this analysis, I conclude this essay with a fundamental reform agenda for reversing the financialization of the US business corporation.

2. The Financialization of the US Business Corporation

By definition, business enterprises need to avoid losses over the long term to survive. Yet investments in innovation inherently entail losses over the periods of time during which the *development and utilization* of products and processes occurs. It is only when the resultant products are sold on the market that the high-fixed costs of the innovation

process are transformed into low unit costs that can potentially generate financial returns (Lazonick 2010b). Investments in innovation, therefore, require committed finance, or “patient capital”. In a company that has already had successful products, the foundation of committed finance is earnings retained out of profits; part of past gains from innovation provides committed finance for the next round of innovation. I call this mode of corporate finance a “retain-and-reinvest” allocation regime.

In historical perspective, the US business corporation of the first half of the twentieth century was relatively unfinancialized, with the stock market’s main role being the separation of stock ownership from managerial control. The widespread fragmentation of shareholding among portfolio investors for companies listed on the New York Stock Exchange (NYSE) left salaried managers in control over corporate resource allocation, in what Alfred Chandler (1977) called “the managerial revolution in American business”. Regular distributions of dividends encouraged stable shareholding, while the corporation prudently leveraged retentions with long-term bond issues to support corporate growth. At established corporations both blue-collar and white-collar workers had realistic expectations of career employment with one company. When economic downturns forced layoffs, the unemployment spells were viewed as temporary, and collective bargaining agreements often provided corporate unemployment benefits that supplemented government unemployment payments.

The conglomerate movement of the 1960s, which reached its peak in 1969, represented the first major movement toward the financialization of US corporate resource allocation. Business schools taught that a good manager could manage anything, while many industrial-organization economists argued that conglomerates enabled efficiencies in capital allocation and utilization of managerial capabilities (Hurley 2006). Catering to a speculative stock market, however, conglomeration often became simply a method of boosting earnings-per-share (EPS) of the company as a whole by using debt issues to finance the acquisition of companies with lower price/earnings ratios. While it should have been clear to stock-market investors that such short-term financial manipulation undermined the financial conditions for sustaining higher levels of EPS over the long term, stock-market speculators were only interested in capitalizing on short-term changes in the market’s evaluation of corporate shares.¹

Deconglomeration of the 1970s and 1980s revealed the weakness of the conglomerate as a productive business model. Even in conglomerates in which acquisitions were not driven primarily by financial motives, strategic decision-makers, isolated at the top in the conglomerate headquarters, tended to be ignorant of the types of resource allocation required for innovative enterprise in the company’s many different lines of business. By the early 1970s the downgraded debt of conglomerates, known as “fallen angels”, created the opportunity for a bond trader, Michael Milken, at the investment bank of Drexel Burnham, to create a liquid market in high-yield “junk bonds”. By the late 1970s companies were issuing junk bonds directly, often to do management buyouts as the “deconglomeration” movement saw conglomerates divest unprofitable conglomerate divisions so that they could become, once again, autonomous firms run by executives who understood the investment requirements of the businesses that they were managing .

¹ See the various articles on conglomeration in St. John’s Law Review, 44, 1969-1970.

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By the mid-1980s Milken (who eventually went to jail for securities fraud) was using his network of financial institutions to back corporate raiders in junk-bond financed leveraged buyouts with the purpose of extracting as much money as possible from a company once it was taken over through layoffs and by breaking up the company to sell it off in pieces (Bruck 1989).

Meanwhile in the 1970s speculative trading in corporate stocks had become much simpler and less costly. In 1971 the creation of the National Association of Security Dealers Automated Quotation (NASDAQ) System out of the fragmented over-the-counter markets dramatically increased the liquidity of the stocks of corporations that did not have the capitalization and profit record required for listing on NYSE (Ingebretsen 2002). In 1974 the Employee Retirement Income Security Act (ERISA) enabled pension funds to invest in corporate stocks on a much larger scale than previously, thus adding an immense amount of liquidity to US stock markets (Ghilarducci 1994; Carey 2010). In 1975 the Securities and Exchange Commission (SEC) barred stock exchanges from charging fixed commissions on trades, ending a practice that had prevailed on Wall Street since 1796. Now it was less costly for stock-market investors to buy and sell shares to realize capital gains as an alternative to holding the shares for a stream of dividend income. Over the course of the decade, Wall Street shifted its business focus from financing the long-term corporate investments to trading in corporate securities (see Auletta 1986; Carrington 1987; Lowenstein 1989).

The launch of NASDAQ in 1971, with its much less stringent listing requirements than the NYSE, made it much easier for a young company with little or no profits to do an initial public offering (IPO), thus enhancing the ability of venture capitalists to use this mode of exit from their private-equity investments. In the early 1970s, however, there was only a trickle of institutional money invested in venture capital, and even that flow dried up when the passage of ERISA in 1974 made corporations responsible for underfunded pensions and pension fund managers personally liable for breaches of their fiduciary duty to use the “prudent man” rule when making investments (Niland 1976). Under these circumstances, pension fund managers, who controlled the allocation of an ever-increasing share of US household savings, avoided investment in venture capital funds. On July 23, 1979, however, the US Department of Labor decreed that pension fund money could be invested not only in listed stocks and high-grade bonds but also in more speculative assets, including new ventures, without transgressing the prudent man rule (Ross 1979). As a result pension fund money poured into venture capital funds.

In 1978, in response to intensive lobbying led by the American Electronics Association and the National Venture Capital Association (both dominated by Silicon Valley interests), the US Congress reduced the capital-gains tax from as high as 49.875 percent to a maximum of 28 percent, thus reversing a 36-year trend toward higher capital-gains taxes. In 1981 the capital-gains tax rate was further reduced to a maximum of 20 percent (Auten 1999). Lower capital-gains taxes encouraged both entrepreneurial investment in new companies and portfolio investment by individuals in the publicly traded stocks of young, potentially high-growth companies.

Venture capital played a central role in the rise of what I have called the “New Economy business model” (NEBM) in contrast to the “Old Economy business model” (OEBM) that

characterized established companies listed on NYSE (Lazonick 2009a). Through the performance of “creation”, “compensation”, and “combination” functions, the stock market became far more important to the operation of the US industrial economy than under OEBM. NEBM relied on prospective stock-market gains through an IPO or merger-and-acquisition (M&A) deal to induce financial capital accumulated in the Old Economy to be transferred to the New Economy in the form of venture capital that would support the *creation* of startups. Through the offer of what came to be known as “broad-based” stock-option plans as an integral component of employee *compensation*, the rise of NEBM relied on prospective stock-market gains to induce professional, technical, and administrative labor to leave secure employment at established companies for insecure employment at startups.² In addition, under NEBM it became common for companies to use their stock rather than cash as a currency for *combination* with other companies; the classic example is Cisco Systems which from September 1993 through July 2003 did 81 acquisitions for \$38.1 billion, 98 percent of which was paid in stock (Lazonick 2009b).

In the 1980s and 1990s, as shown in Table 1, high real stock yields characterized the US corporate economy. These high yields came mainly from stock-price appreciation as distinct from dividend yields, which were low in the 1990s despite high dividend payout ratios (US Congress 2010, Table B-90). There are three distinct forces – *innovation*, *speculation*, and *manipulation* – that may increase stock prices. Innovation generates higher quality, lower cost products that result in sustainable increases in earnings per share, which in turn tend to lift the stock price of the innovative enterprise. Speculation, often encouraged by innovation, drives the stock price higher, as investors assume either that innovation (which is inherently uncertain) will continue in the future or that there is a “greater fool” who stands ready to buy the stock at yet a higher price. Manipulation occurs when those who control corporate resource allocation do so in ways that increase earnings per share despite the absence of innovation.

Table 1: Average annual US corporate stock and bond yields (%), 1960-2009

	1960-1969	1970-1979	1980-1989	1990-1999	2000-2009
Real stock yield	6.63	-1.66	11.67	15.01	-3.08
Price yield	5.80	1.35	12.91	15.54	-2.30
Dividend yield	3.19	4.08	4.32	2.47	1.79
Change in CPI	2.36	7.09	5.55	3.00	2.57
Real bond yield	2.65	1.14	5.79	4.72	3.41

Stock yields are for Standard and Poor's composite index of 500 US corporate stocks. Bond yields are for Moody's Aaa-rated US corporate bonds.

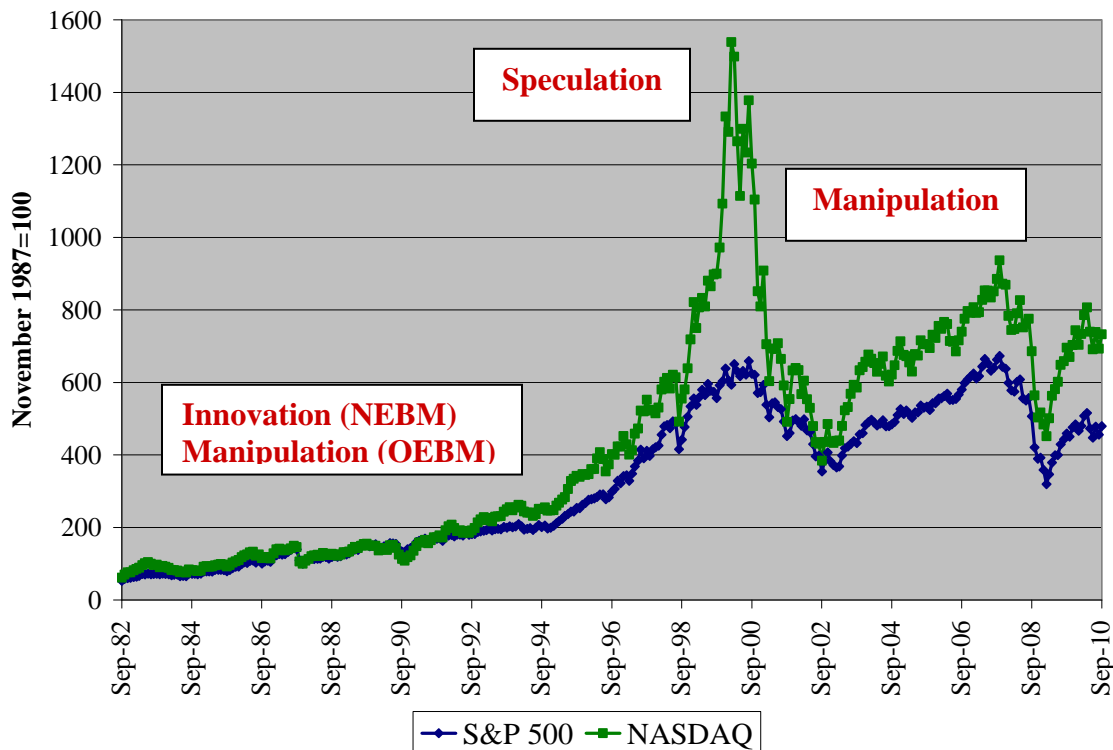
Source: US Congress 2010, Tables B-62, B-73, B-95, B-96.

Figure 1 charts the roles of innovation, speculation, and manipulation as *primary* drivers of US stock-price movements from the mid-1980s to the late 2000s. In the last half of the 1980s Old Economy companies that had run into trouble because of conglomeration in

² A stock option award gives an employee the non-transferable right to purchase a certain number of shares of the company for which he or she works at a pre-set “exercise” price between the date the option “vests” and the date it “expires”. Typically in US option grants, the exercise price is the market price of the stock at the date that the option is granted; vesting of the option occurs in 25% installments at each of the first four anniversaries from the grant date; and the expiration date of the option is ten years from the grant date. Unvested options usually lapse 90 days after termination of employment with the company.

the United States or competition from the Japanese sought to manipulate stock prices through a “downsize-and-distribute” resource-allocation strategy that downsized the labor force and distributed corporate revenues to shareholders in the forms of dividends and stock repurchases (Lazonick 2004). This redistribution of corporate revenues from labor to capital often occurred through debt-financed hostile takeovers, with post-takeover downsizing enabling the servicing and retirement of the massive debt that a company had taken on. In addition, from the mid-1980s, many Old Economy companies engaged for the first time in large-scale stock repurchases in an attempt to support their stock prices.

Figure 1. S&P 500 and NASDAQ Composite Indices, Sept. 1982-Sept. 2010
(monthly data, standardized for the two indices to 100 in Nov. 1987)



As of September 2010 the S&P 500 Index consisted of 500 stocks, of which 406 were NYSE and 94 NASDAQ; and the NASDAQ Composite Index consisted of 2,910 stocks.

Source: Yahoo! Finance at <http://finance.yahoo.com> (Historical Prices, Monthly Data).

While in the 1980s and early 1990s Old Economy companies used “downsize-and-distribute” to manipulate stock prices, New Economy companies such as Intel, Microsoft, Cisco Systems, and Dell, reinvested virtually all of their incomes to finance the growth of their companies, neither paying dividends nor, once they had gone public, repurchasing stock (Lazonick 2009a, ch. 2). It was *innovation* by New Economy companies, most of them traded on NASDAQ, that culminated in the Internet revolution that provided a real foundation for the rising stock market in the 1980s and first half of the 1990s.

In the late 1990s, however, *speculation* drove the stock market as the public discovered the existence of innovative New Economy firms, and then began making bets on many

dot.com startups that had little innovative capability. The rise and fall of the NASDAQ Composite Index between 1998 and 2001 (Figure 1) make the movements of the Dow Jones Industrial Average (DJIA), which at the time included Intel and Microsoft as the NASDAQ representatives among its 30 stocks, and the S&P 500 Index, the composition of which is over 80 percent NYSE and under 20 percent NASDAQ, look like mere blips. Between March 1998 and March 2000, the NASDAQ Composite Index of over 3,000 stocks rose by 149 percent compared with 21 percent for the DJIA and 36 percent for the S&P 500 (US Congress 2010, Table B-90).

Especially from 2003 stock repurchases became the key instrument of stock-market *manipulation*. A stock repurchase occurs when a company buys back its own shares. In the United States, the SEC requires stock repurchase *programs* to be approved by the company's board of directors and to be announced publicly. These programs authorize a company's top executives to do a certain amount of buybacks over a certain period of time, with the timing and amount of the repurchases left to the discretion of the executives. Repurchases are almost always done as open-market transactions through the company's broker. The company is not required to announce the buybacks at the time they are actually done.

Data on 373 companies in the S&P 500 Index in January 2008 that were publicly listed in 1990 show that they expended an annual average of \$106.3 billion (or \$285 million per company) on stock repurchases in 1995-1999, representing 44 percent of their combined net income. These figures represented a significant increase from \$25.9 billion in repurchases (or \$69 million per company) in 1990-1994, representing 23 percent of their combined net income. Yet in the late 1990s the stage was being set for an even more massive manipulation of the market through stock repurchases. Figure 2 shows the payout ratios and mean payout levels for 437 companies in the S&P 500 Index in January 2008 that were publicly listed from 1997 through 2008.³

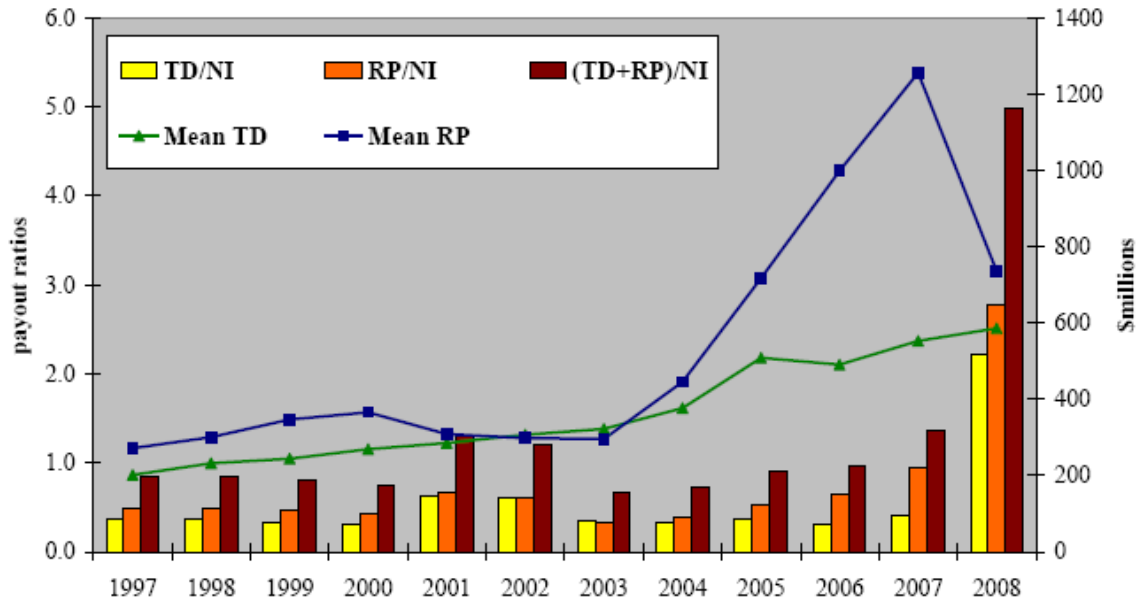
From 1997 through 2008 these 437 companies expended \$2.4 trillion on stock repurchases, an average of \$5.6 billion per company, and distributed a total of \$1.6 trillion in cash dividends, an average of \$3.8 billion per company. Stock repurchases by these 437 companies averaged \$296 million in 2003, rising to \$1,256 million in 2007. Combined, the 500 companies in the S&P 500 Index in January 2008 repurchased \$436 billion of their own stock in 2006, representing 64 percent of their net income, and \$549 billion in 2007, representing 94 percent of their net income.

Escalating stock repurchases from 2003 through 2007 helped to boost the stock market, driving the S&P 500 Index even higher in 2007 than its previous peak in 2000 before the 2008 financial debacle. In 2008 repurchases fell substantially for these 437 companies, constrained by a dramatic decline in combined net income from \$584 billion in 2007 to \$116 billion in 2008. Nevertheless, their combined repurchases only declined from \$549 billion to \$322 billion. As a result, the repurchase payout ratio almost tripled from 0.94:1

³ Many firms that were big repurchasers before the financial crisis of 2008 dropped out of the S&P 500 in 2009. To capture more fully the extent of repurchases in the years before the financial meltdown, I use the sample of companies in the S&P 500 in January 2008. Buybacks fell further in 2009, but rebounded in 2010.

to 2.78:1. In addition, these companies paid out \$14 billion more in dividends in 2008 than in 2007, with the result that the dividend payout ratio leapt from 0.41:1 to 2.21:1. Allocated differently, the billions spent on buybacks could have helped stabilize the economy. Instead, collectively, these companies not only spent all their profits on repurchases but also ate into their capital.

Figure 2: Ratios of cash dividends and stock repurchases to net income, and mean dividend payments and stock repurchases among S&P 500, 1997-2008



Data for 437 corporations in the S&P 500 Index in January 2008 that were publicly listed 1997-2008. Data for companies that end their fiscal years during the first six months of the calendar year are attributed to the previous year.

RP, stock repurchases; TD, total dividends (common and preferred); NI, net income (after tax with inventory evaluation and capital consumption adjustments).

Sources: S&P Compustat database (North America, Fundamentals Annual, 1997-2008); company 10-K filings for missing or erroneous data from the Compustat database.

The facility with which US corporations can do large-scale stock repurchases is the result of the relaxation of SEC rules against stock-price manipulation. Under the Securities Exchange Act of 1934, stock repurchases can be construed as an attempt to manipulate a company’s stock price. In 1982, however, SEC Rule 10b-18 provided companies with a “safe harbor” that manipulation charges would not be filed if each day’s open-market repurchases were not greater than 25 percent of the stock’s average daily trading volume and if the company refrained from doing buybacks at the beginning and end of the trading day.⁴

According to a contemporary news report, Rule 10b-18 “made it easier for companies to buy back their shares on the open market without fear of stock-manipulation charges” (Hudson 1982). SEC Chairman John Shad was an advocate of the rule change, arguing

⁴ In 2003 the SEC amended Rule 10b-18 “to simplify and update the safe harbor provisions in light of market developments since the Rule’s adoption.” The amendments also required that in their 10-Q filings with the SEC companies report the number and value of share repurchased in the previous quarter and the average price paid per share. See <http://www.sec.gov/rules/final/33-8335.htm>.

that large-scale open market purchases would fuel an increase in stock prices that would be beneficial to shareholders. One of the SEC Commissioners, John Evans, argued that as a result of Rule 10-18b some manipulation would go unprosecuted, but then agreed to make the Commission's vote for the rule change unanimous.

3. Stock Buybacks and Executive Pay

Why do corporations repurchase stock? Executives often claim that buybacks are financial investments that signal confidence in the future of the company and its stock-price performance (Louis and White 2007; Vermaelen 2005, ch. 3). In fact, however, companies that do buybacks never sell the shares at higher prices to cash in on these investments. To do so would be to signal to the market that its stock price had peaked. According to the "signaling" argument, we should have seen massive sales of corporate stock in the speculative boom of the late 1990s, as was in fact the case of US industrial corporations in the speculative boom of the late 1920s when corporations took advantage of the speculative stock market to pay off corporate debt or bolster their corporate treasuries (O'Sullivan 2004). Instead in the boom of the late 1990s corporate executives as *personal investors sold their own stock* to reap speculative gains, often to the tune of tens of millions (see Gimein et al. 2002). Many of these same corporate executives as *corporate decision-makers* used corporate funds to repurchase their companies' shares in the attempt to bolster their stock prices – to their own personal gain.

Indeed, as a complement to the SEC's Rule 10b-18 of 1982, in 1991 SEC made a rule change that enabled top executives to make quick gains by exercising their stock options and immediately selling their shares. Under Section 16(b) of the 1934 Securities Exchange Act corporate directors, officers or shareholders with more than 10 percent of the corporation's shares are prohibited from making "short-swing" profits through the purchase and the subsequent sale of corporate securities within a six-month period. As a result, top executives who exercised stock options had to hold the acquired shares for at least six months before selling them. Treating a stock option as a derivative, the SEC deemed that the six-month holding period required under Section 16(b) was from the *grant* date, not the exercise date (Rosen 1991). The new rule eliminated the risk of loss between the exercise date and the sale date, and gave top executives flexibility in their timing of option exercises and immediate stock sales so that they could personally benefit from, among other things, price boosts from buybacks.

There are a number of ways in which stock options as a mode of executive compensation can be abused. A company might reprice options that are underwater by cancelling an existing option and replacing it with a new option with a lower exercise price (Chance et al. 2000). As a result, an executive may be able to reap gains from stock-option grants even when the company's stock price declines. In 2006 a scandal broke out over the practice of backdating stock options – that is, granting option awards today as if they were granted at an earlier date when the market price of the stock and hence the exercise price of the options were lower (Lie 2005).

These abuses aside, however, the more fundamental problem with US-style stock options is that they are unindexed; that is, they virtually never carry any performance criteria that would only permit an executive to gain from the exercise of stock options when the

company's stock-price increases are greater than those warranted by productive performance (Bebchuk and Fried 2004). As a result, an executive, or any other employee with stock options, can gain from a speculative stock market as distinct from an improvement in the company's productive performance. In addition, as we have seen, executives can augment their stock-option gains by allocating corporate resources to do buybacks, the sole purpose of which is to manipulate the company's stock price. Some of the stock-based compensation of US executives is undoubtedly attributable to innovation, but since the last half of the 1990s it has been speculation and manipulation that have been the main drivers of the explosion in the pay of US corporate executives.

Table 2 shows the average compensation of the highest paid corporate executives in the United States, and the percent of that compensation derived from exercising stock options (the difference between the stock-option exercise price and the market price of the stock on the exercise date). Also included in Table 2 are the S&P 500 Index (with over 80 percent of its component stocks being NYSE) and NASDAQ Composite Index to illustrate the positive correlation of stock-price performance with both the level of executive pay and the proportion of that pay derived from stock-option exercises. The impact of NASDAQ on executive pay was especially strong in the late 1990s when speculation drove stock prices, whereas companies listed on NYSE as well as NASDAQ were engaged in large-scale stock repurchases that helped to manipulate the S&P 500 Index from 2003 to 2007.

As can be seen in Table 2, large proportions of these enormous incomes of top executives have come from gains from cashing in on the ample stock option awards that their boards of directors have bestowed on them. The higher the "top pay" group, the greater the proportion of the pay of that group that was derived from gains from exercising stock options. For the top 100 group in the years 1992-2009, this proportion ranged from a low of 44 percent in 2009, when the mean pay of the group was at its lowest level in real terms since 1995, to 87 percent in 2000, when the mean pay was at its highest. In 2000 the mean pay of the top 3000 was, at \$10.8 million, only ten percent of the mean pay of the top 100. Nevertheless, gains from exercising stock options accounted for 67 percent of the total pay of the top 3000 group.

Note in Table 2 how the average pay of the highest paid corporate executives has risen and fallen with the fluctuations of major stock market indices. In the 1980s and 1990s, as was shown earlier in Table 1, high real stock-price yields characterized the US corporate economy. With the S&P 500 Index rising almost 1,400 percent from March 1982 to August 2000, the availability of gains from exercising stock options became almost automatic. In the 2000s, with the stock market less speculative, the gains came primarily from manipulation, with repurchases as the instrument for boosting stock prices. Given the extent to which the explosion in US top executive pay over the past three decades has been dependent on gains from exercising stock options, any policy initiatives to control executive pay must recognize the changing roles of innovation, speculation, and manipulation as drivers of the stock-price increases that generate these gains. These policies should seek to reward executives, along with other corporate participants, for their contributions to innovation while eliminating the gains from speculation and manipulation. The failure to do so not only has contributed to a highly inequitable

distribution of income but also, as I will outline in the next section, has done significant damage to the possibilities for innovation and job creation in the US economy.

Table 2. Total compensation of top executives of US-based corporations, average for 100, 500, 1500, and 3000 highest-paid executives, and the proportion of total compensation derived from gains from exercising stocks options, 1992-2009

Mean compensation in millions of 2009 US dollars

	S&P 500 Index	NAS-DAQ Index	NAS-DAQ/S&P	Top 100		Top 500		Top 1500		Top 3000	
				Mean \$m.	% SO	Mean \$m.	% SO	Mean \$m.	% SO	Mean \$m.	% SO
1992	100	100	1.00	22.7	71	9.2	59	4.7	48	2.9	42
1993	109	119	1.10	20.9	63	9.0	51	4.7	42	3.1	36
1994	111	125	1.13	18.2	57	8.0	45	4.3	35	2.9	29
1995	131	155	1.18	20.5	59	9.6	48	5.2	40	3.4	34
1996	162	195	1.20	31.8	64	13.7	54	7.1	47	4.5	41
1997	210	243	1.16	43.3	72	18.2	61	9.3	55	5.8	49
1998	261	300	1.15	76.9	67	26.8	65	12.5	59	7.5	54
1999	319	462	1.45	68.8	82	27.4	71	13.2	63	7.9	57
2000	341	614	1.80	103.7	87	40.3	80	18.6	73	10.8	67
2001	284	332	1.17	62.1	77	23.6	66	11.3	58	6.8	53
2002	237	252	1.06	37.3	57	16.7	49	8.6	43	5.4	38
2003	232	275	1.18	48.2	64	20.9	55	10.7	48	6.7	43
2004	272	330	1.21	54.4	75	24.5	62	12.8	55	8.0	50
2005	290	348	1.20	66.3	78	28.1	63	14.2	56	8.9	51
2006	316	463	1.47	67.1	68	28.9	58	15.0	51	9.5	46
2007	354	428	1.21	59.4	69	27.3	58	14.5	50	9.3	45
2008	291	356	1.22	39.1	62	16.5	48	8.3	38	5.0	33
2009	227	307	1.35	29.6	44	13.9	27	7.7	17	5.0	12

S&P 500 Index and the NASDAQ Composite Index set to 100 in 1992 for purposes of comparison.

Total compensation (TDC2 in the Compustat database) is defined as “Total compensation for the individual year comprised of the following: Salary, Bonus, Other Annual, Total Value of Restricted Stock Granted, Net Value of Stock Options Exercised, Long-Term Incentive Payouts, and All Other Total”.

%SO means the percent of total compensation that the whole set (100, 500, 1,500, or 3,000) of highest-paid executives derived from gains from exercising stock options.

Note that company proxy statements (DEF 14A SEC filings) report the compensation of the company’s CEO and four other highest paid executives. It is therefore possible that some of the highest-paid executives who should be included in each of the “top” categories are excluded. The mean compensation calculations are therefore lower bounds of actual average compensation of the highest paid corporate executives in the United States.

Sources: Standard and Poor’s Compustat database (Executive Compensation, Annual); Yahoo! Finance at <http://finance.yahoo.com> (Historical Prices, Monthly Data).

4. Impacts of Financialization on Economic Performance

In work reported elsewhere, I have examined how buybacks have adversely affected the delivery of higher quality, lower cost products in a range of industries from oil refining to

health insurance (Lazonick 2009b; 2010c; Lazonick and Tulum 2011). Some brief examples:

- Exxon Mobil, the world's largest petroleum refiner, did \$163.7 billion in buybacks during 2000-2009 – the most of any company – even as there is a need for large-scale investments in energy alternative. Among the top 50 stock repurchasers in 2000-2009 were two other petroleum refiners: Chevron at #18 with \$26.8 billion and ConocoPhillips at #33 with \$18.1 billion.
- Leading ICT companies do massive buybacks even as they shift high-tech jobs from the United States to low-wage countries and pressure the US government to make larger investments in the high-tech knowledge base. Yet the \$46.5 billion that Intel spent on buybacks in 2001-2009 was more than four times the total of \$10.1 billion that, over the same period, the US government allocated to the National Nanotechnology Initiative.
- Pharmaceutical drug prices are at least double in the United States compared with other countries. The industry benefits from government-funded life sciences research under the National Institutes of Health, the total annual budget of which was \$30.2 billion in 2009 and \$30.9 billion in 2010. In opposing Congressional regulation of drug prices, the industry argues that high prices fund R&D expenditures in the United States. Yet among leading pharma biopharma companies, in 1997-2009 Amgen did repurchases equal to 99 percent of R&D expenditures, Pfizer 67 percent, Merck 62 percent, and Johnson & Johnson 57 percent.
- Among the top 50 repurchasers in the United States for the period 2000-2009 were three of the largest corporate health insurers: UnitedHealth Group at #24 with \$25.2 billion in buybacks (96 percent of net income), Wellpoint at #39 with \$17.5 billion (2 percent), and Aetna at #49 with \$10.4 billion (125 percent). When these health insurers increase their profits by raising premia, excluding people with pre-existing conditions, and capping lifetime benefits, the most likely use of those extra profits is to do more stock buybacks.
- Among the biggest stock repurchasers in the years prior to the financial crisis were many of financial corporations that were responsible for the meltdown, a few of which went bankrupt and many of which were bailed out under the Troubled Asset Relief Program. By spending money on buybacks during boom years, these financial corporations reduced their ability to withstand the crash of the derivatives market in 2008, thus exacerbating the jeopardy that they created for the economy as a whole.

US-style stock options provide the top executives of US business corporations, be they in manufacturing, services, or finance, with ample personal incentives to do stock buybacks even if it is at the expense of investments in innovation and job creation. Under any circumstances, an economy needs investment in innovation to generate economic growth. What renders the US economy particularly fragile is that over the past three decades the financialization of the industrial corporation has gained strength even as major structural

changes in US employment that have eroded the *existing* opportunities for middle-class jobs.

During the post-World war II decades, for both blue-collar and white-collar workers, the “retain-and-reinvest” norm in Old Economy corporations was career employment with one company. When layoffs occurred, they tended to be temporary and, in unionized workplaces, on a last-hired, first-fired basis. Supported by a highly progressive income tax system, countercyclical government economic policy sought to reduce the severity of business fluctuations, while government spending, particularly on higher education, advanced technology and physical infrastructure, complemented the employment opportunities provided by the business sector. The result was relatively equitable and stable economic growth from the late 1940s to the beginning of the 1970s (Lazonick 2009a, chapters 1 and 3).

From the late 1970s, however, in industries that had been central to US innovation, employment, and growth, US corporations faced formidable Japanese competition. The Japanese challenge came in industries such as automobiles, consumer electronics, machine tools, steel, and microelectronics in which the United States had been a world leader. The critical source of Japan’s competitive advantage over the United States was “organizational integration”; through the hierarchical integration of shop-floor workers and the functional integration of technical specialists into processes of organizational learning, the Japanese perfected the US Old Economy business model (Lazonick 1998 and 2010a). Even though unionized blue-collar workers in the United States had a high degree of job security in the post-World War II decades, they had historically been excluded from the processes of organizational learning that occurred within the managerial organization. In sharp contrast, the hierarchical integration of shop-floor workers into the organizational learning processes that generated higher quality, lower cost products was the prime source of Japanese competitive advantage. Complementing the hierarchical integration of shop-floor workers, the collaboration of Japanese technical specialists in solving productivity problems in manufacturing encouraged the functional integration of their skills and efforts, again in contrast to the relatively high degree of functional segmentation of technical specialists in the United States.

The adverse impact of Japanese competition on US employment became particularly harsh in the double-dip recession of 1980-1982 when large numbers of good blue-collar jobs disappeared, as it turned out permanently, from US industry (Bednarzik 1983). Previously, in a more stable competitive environment, US manufacturing companies would lay off workers with the least seniority in a downturn and re-employ them when economic conditions improved. Now companies were much more likely to shutter whole plants (Harris 1984; Hamermesh 1989). Over the course of the 1980s the stock market came to react favorably to permanent downsizings of the blue-collar labor force (Abowd et al. 1990; Palmon et al. 1997). While terminations could represent the initial stage of restructuring that could enhance the long-run competitiveness of a company, downsizing was often the result of attempts by corporate executives and corporate raiders to “maximize shareholder value”, a new ideology of corporate governance (Lazonick 2004; Lazonick and O’Sullivan 2000). As secure middle-class jobs for high-school-educated blue-collar workers permanently disappeared, there was no commitment on the part of those who managed US industrial corporations or the Republican Administrations

that ruled in the 1980s to invest in the new capabilities and opportunities required to upgrade the quality and expand the quantity of well-paid employment opportunities in the United States on a scale sufficient to reestablish a regime of reasonably equitable and stable economic growth.

Among blue-collar workers, black workers were extremely hard hit by the rationalization of employment in the 1980s. They were overrepresented in the Old Economy manufacturing sectors such as steel, autos, and consumer electronics that were in decline and underrepresented in the New Economy sectors related to the microelectronics revolution that were on the rise. Besides losing jobs when plants were closed, many blacks had recently moved into unionized jobs so that when some workers in an establishment were laid off, they tended to be last hired and hence first fired (see Kletzer 1991; Sharpe 1993; Fairlie and Kletzer 1998). As William Julius Wilson (1996-1997) argued, the disappearance of these jobs had devastating impacts on the abilities and incentives of blacks to accumulate the education and experience required to position themselves for well-paid and stable employment opportunities.

In historical retrospect we now know that the recoveries that followed the recessions of 1990-1991, 2001, and 2007-2009 were “jobless”. The recovery from the recessionary conditions of 1980-1982 was not “jobless” because employment opportunities created by the microelectronics boom in the first half of the 1980s offset the joblessness that remained in the traditional manufacturing sector as the US economy began to grow. In particular, the recovery from the recession of 1980-1982 saw the emergence of what would become the Wintel architecture around the IBM PC (Chandler 2001, chs. 4-5).

The first jobless recovery in the early 1990s reflected the marketization of the employment relation that was integral to the transition from OEBM to NEBM. The downturn of 1990-1991 is known as a “white-collar recession”. Although in absolute terms, blue-collar workers suffered more unemployment than white-collar workers during this recession, the extent to which professional, technical, and administrative employees were terminated was unprecedented in the post-World War II decades (Eberts and Groshen 1991; Gardner 1994). It also marked the beginning of the end of the career-long employment security that people in their 40s and 50s had come to expect under OEBM.

Given its size, reputation, and central position in the ICT industries, IBM’s transformation from OEBM to NEBM in the early 1990s marked a fundamental juncture in the transition from employment security to employment insecurity in the US corporate economy. Through the 1980s IBM touted its practice of “lifelong employment” as a source of its competitive success. From 1990 to 1994 IBM cut employment from 373,816 to 219,839 (Lazonick 2009a, ch. 3). Of IBM’s losses of \$15.9 billion in 1991-1993, 86 percent came from workforce-related restructuring charges (including the cost of employee separations and relocations) – in effect the cost to the company of ridding itself of its once-hallowed tradition of lifelong employment. By 1994, when the company booked no restructuring charges and had after-tax profits of \$3,021 million, lifelong employment at IBM was a thing of the past. In line with the IBM transition, for the period of 1992 to 1997, John Abowd et al. (2007) found a general shift in US employment from older experienced workers to younger skilled workers related to the adoption of computer technologies.

With the decline of a career with one company, in the 1990s middle-aged and older men began to experience unprecedented rates of job displacement (Kletzer 1998; Schultze 1999). A survey of changes in job security showed that in the 1990s and 2000s members of the US labor force experienced shortened job tenure, with the impact being most pronounced for males. Moreover, education and experience are no longer the guarantors of employment security that they once were (Farber 2008). Even in the boom of the late 1990s, corporations often replaced more senior, more expensive, workers with younger, less expensive workers for the purpose of increasing the bottom line.

In the 2000s globalization joined rationalization and marketization as a source of structural change in the employment opportunities available to the US labor force. In the ICT industries that were central to the growth of the US economy in the 1980s and 1990s, the globalization of employment dated back to the 1960s when US semiconductor manufacturers had set up assembly and testing facilities in East Asia, making use of low-paid but literate female labor (Lazonick 2009a, ch. 5). Over time, a combination of work experience at home with both multinational and indigenous companies as well as the return of nationals who had acquired graduate education and/or work experience abroad enhanced the capabilities of the Asian labor force to engage in higher value-added activities. By the beginning of the 2000s Indians had become world leaders in the offshore provision of IT services while the Chinese had become adept in a wide range of manufacturing industries, especially in ICT. In the 2000s the availability of a capable college-educated labor supply along with enhanced and low-cost communication technology led to a vast acceleration of offshoring by US companies to China and India (Bronfenbrenner and Luce 2004; Bednarzik 2005; Blinder 2007; Hira and Hira 2008; Houseman 2009).

Offshoring depressed US employment in the recession of 2001 and in the subsequent jobless recovery that stretched into 2003. Now well-educated high-tech workers found themselves vulnerable to displacement as US-based companies hired workers abroad (Garner 2004; Jensen and Kletzer 2005). Given huge increases in the issuance of non-immigrant (H-1B and L-1) work visas in the United States in the late 1990s and beginning of the 2000s, there were hundreds of thousands of high-tech workers, especially Indians, who had accumulated US work experience that they could now take back home.

It should be emphasized that the permanent displacement of workers from middle-class jobs by rationalization, marketization, and globalization often has a productive rationale: manufacturing plants may become uncompetitive; recently educated workers may possess more relevant skills than experienced (older) workers; and the productivity of workers in low-wage areas of the world may be on a par if not superior to that of workers in the United States. Nevertheless, especially once changes in the structure of employment have become widespread for productive reasons, US corporations have been known to terminate employees in order to increase short-term profits for the sake of inciting speculative increases in their company's stock price. The tendency has then been to allocate those extra profits to stock buybacks so that manipulation as well as speculation can drive up the price of the company's stock. Legitimizing both the

elimination of existing jobs and the failure to create new jobs is the ideology that companies should be run to “maximize shareholder value”.⁵

Unlike the recessions of 1980-1982, 1990-1991, and 2001, the Great Recession of 2008-2009 was a purely financial downturn caused by speculation and manipulation in the financial sector of the economy. At the same time, that speculation and manipulation exploited the fragility of homeownership in an economy that since the 1980s had been eliminating middle-class jobs from the industrial sector. The US labor force is now experiencing its third, and longest, jobless recovery. While Wall Street has become and remains a gambling casino, the more fundamental fragility of the US economy emanates from the industrial sector. As a general rule, the executives who run the financialized US industrial corporations seek to create profits for the sake of higher stock prices, not jobs for the sake of equitable and stable economic growth.

5. An Agenda for Corporate Reform

I have argued that the stock-based pay that enables corporate executives to gain from speculation and manipulation of the stock market makes the US economy not only inequitable but also unstable. To reap the gains from speculation and manipulation, executives often make resource allocation decisions such as financially-driven acquisitions and stock buybacks that ultimately undermine the conditions of innovative enterprise. At the same time, the US economy is highly dependent on innovative enterprise not only to generate economic growth but also to create sustainable employment opportunities for the population that can, at a minimum, replace the middle-class jobs that through rationalization, marketization, and globalization the US economy has lost over the past three decades. Instead the financialization of the US corporation has exacerbated the loss of jobs from these structural changes in employment.

When there is job displacement because of rationalization, marketization, and globalization, business and government must collaborate to ensure the availability of the education and training needed to reposition displaced workers to perform new productive roles in the economy. The financialized corporation tends to opt out of this collaborative effort because it operates according to an ideology – “maximizing shareholder value” – that argues that it has no responsibility for the unemployed. In doing so, the financialized corporation not only avoids a share of the cost of retraining its workers but also fails to participate in making the investments that can generate new and potentially sustainable middle-class jobs for the US labor force.

Government investment in physical infrastructures such as communication networks and transportation systems as well as human infrastructures such as higher education and research facilities provides an essential foundation for business investment, especially in high-tech fields (Lazonick 2008; Block and Keller 2011). Government subsidies to business, often implemented through tax legislation, can serve as further inducements to business investment. In the United States, government funding has been critical to the emergence and development of high-tech sectors such as computers, the Internet, and biotechnology.

⁵ For a critique of this ideology as espoused by agency theorists, see Lazonick 2010c.

But for these government investments and subsidies, the United States would not lead the world in venture capital – an industry devoted to new-firm formation and growth. Yet, in the United States, a disproportionate share of the returns to a successful new venture accrue to those entrepreneurs and financiers who put an innovation on the market while neglecting the contributions of other stakeholders, especially taxpayers, who made significant contributions to the innovation process (see Lazonick 2009a). In the name of “shareholder value,” rewards are reaped at the expense of different non-shareholding stakeholders who risked their labor and capital in the collective and cumulative innovation process.

Once a new venture has become a going concern, shareholder-value ideology continues to hold sway. Innovation may drive stock prices for a while, and through broad-based stock-options plans thousands of employees can share the gains. But the use of stock options as a mode of compensation means that the realization of gains depends on selling, not holding, ownership stakes. Moreover, in an exploding stock market as occurred in the Internet boom of 1996-2000, the returns to option holders reflect gains from speculation much more than gains from innovation. Furthermore, even in the tight labor markets of the Internet boom, high-tech employees who could potentially reap large gains from the exercise of stock options were also vulnerable to being thrown out of work through marketization and globalization (Lazonick 2009a and 2009b).

In the 2000s up to the financial crisis of 2008, it was manipulation much more than innovation or speculation that drove stock prices. Through the escalation of stock buybacks from 2003 to 2007, the S&P 500 Index peaked in 2007 at a higher level than that achieved through the often wildly speculative stock valuations of 2000. In effect in the period 2003-2007 major US companies used escalating stock buybacks to compete with one another to boost their stock prices and manage quarterly EPS. In the Great Recession of 2008-2009 stock prices tumbled as did stock buybacks. By 2010 US companies were profitable again, but they both increased buybacks and still sat on huge cash reserves (in some cases augmenting these reserves by borrowing money at very low interest rates), preparing themselves, according to my prognosis, for a renewed competitive escalation of buyback activity (Jewell 2010; Krantz 2011). Just as the cause of the Great Recession was the financialized business corporation, so too the subsequent jobless recovery is the result of the continued domination of shareholder-value ideology and practice in the US corporation.

In my view, therefore, any government policy agenda that seeks to recreate the middle class in the United States needs to begin with an attack on the financialized business corporation. This policy agenda then needs to engage in constructive programs in collaboration with a nonfinancialized business community to rebuild the capabilities of the US labor force to engage in innovative enterprise. The policy agenda for sustainable prosperity includes, in brief,⁶ five major reforms:

⁶ Details of these reforms are available in Lazonick 2011.

Lazonick: Reforming the Financialized Business Corporation

- *Ban stock repurchases by established US corporations so that corporate financial resources that could be allocated to innovation and job creation are not wasted for the purpose of manipulating a company's stock price.*
- *Index employee stock options to an indicator of innovative performance so that executives cannot gain from speculation in and manipulation of their companies' stock prices.*
- *Regulate the employment contract to ensure that workers who contribute to the innovation process share in the gains to innovation.*
- *Create work programs that make productive use of and enhance the productive capabilities of educated and experienced workers whose human capital would otherwise deteriorate through lack of other relevant employment.*
- *Implement taxes on the gains from innovation to fund those government agencies that need to invest in the public knowledge base required for the next round of innovation.*

It will be very difficult to justify these reforms if Americans do not question the ideology that companies should be run to “maximize shareholder value” (Lazonick 2010c). It is an ideology that results in inequity and instability and that ultimately undermines the productive foundations of economic growth. While shareholder-value ideology has currency throughout the world, its pervasive and unquestioned acceptance has become an almost uniquely American phenomenon. The United States is engaged in global competition with highly innovative national economies in which shareholder-value ideology does not hold sway. As long as US-based corporations are permitted to be governed by this ideology, the US economy will remain incapable of generating middle-class jobs on the scale that is needed to restore sustainable prosperity. Indeed, judging from the changes in employment that have occurred in the US economy over the past three decades, the achievement of equitable and stable growth will become more and more out of reach.

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